Financial supervisory architecture: what has changed after the crisis?

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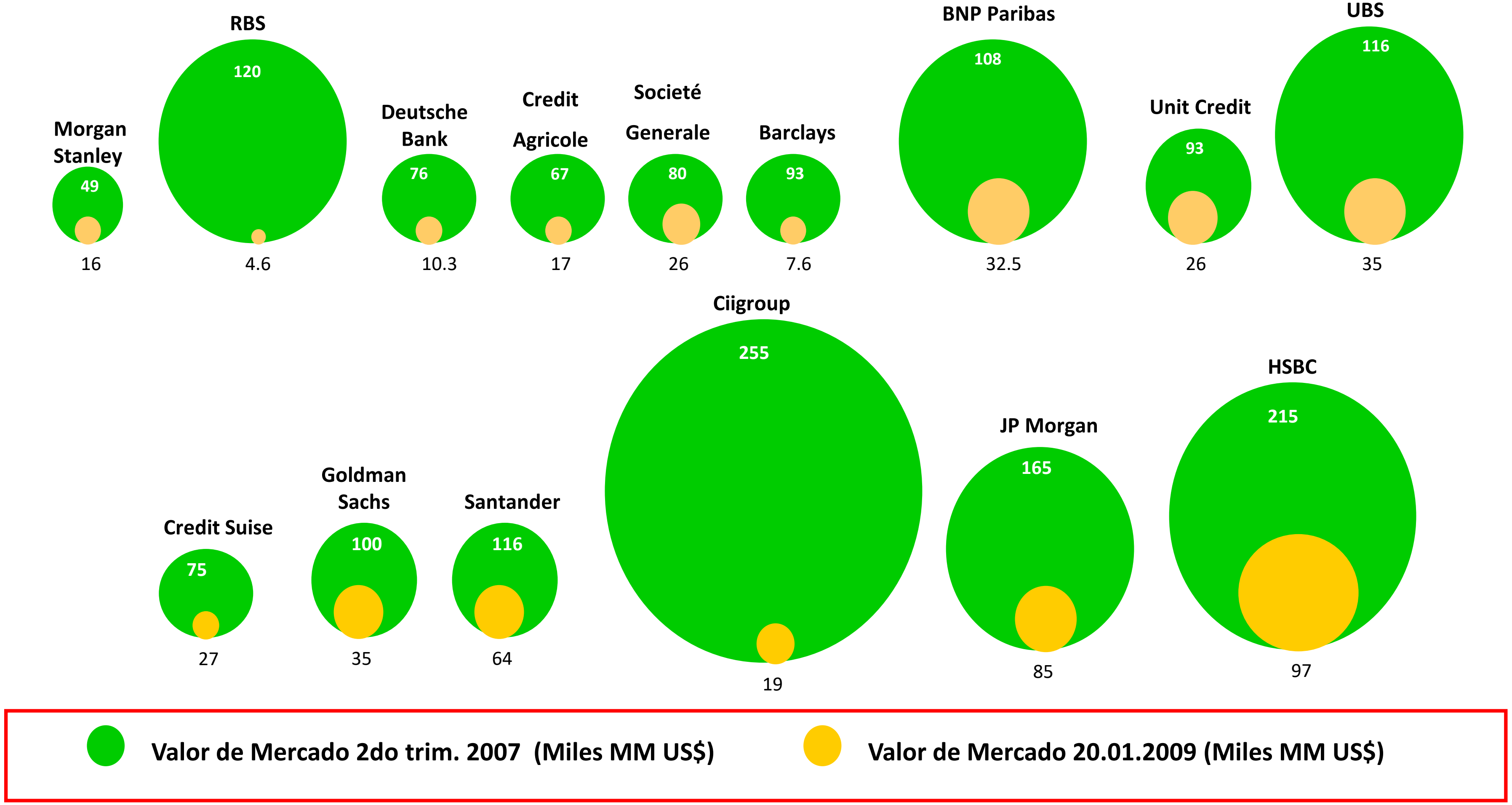
Índice

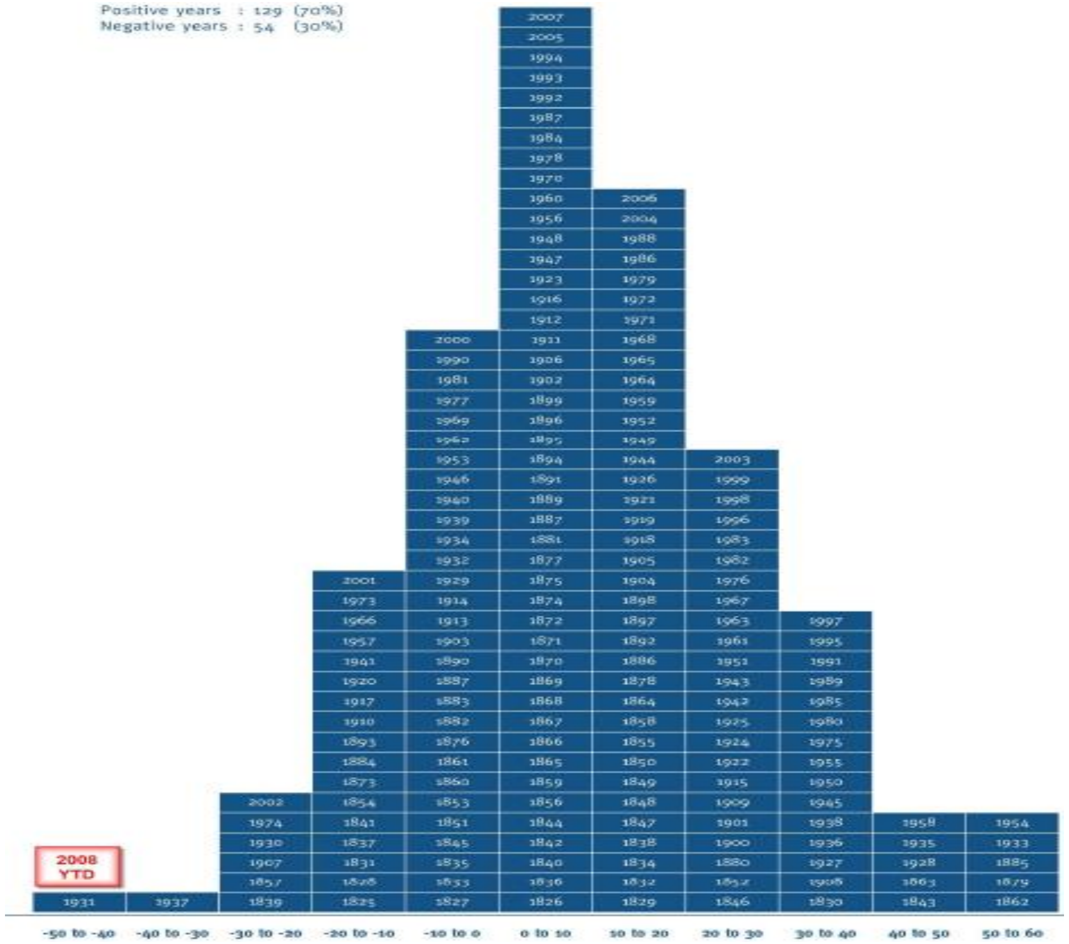
I. International Financial Crisis

Financial crisis significantly impacted market value of international financial institutions



Source: Bloomberg

S&P500: One of the worst years



Si hace **UN AÑO ATRÁS** usted hubiera invertido US$ 1.000 en acciones de ... al 15 de octubre del 2008 ...

Empresas en Crisis	Le Quedó US$	Pérdida %
FannieMae	32,9	96,7
AIG	20,3	98,0
Freddie Mac We make home possible	6,3	99,4
LEHMAN BROTHERS	3,2	99,7

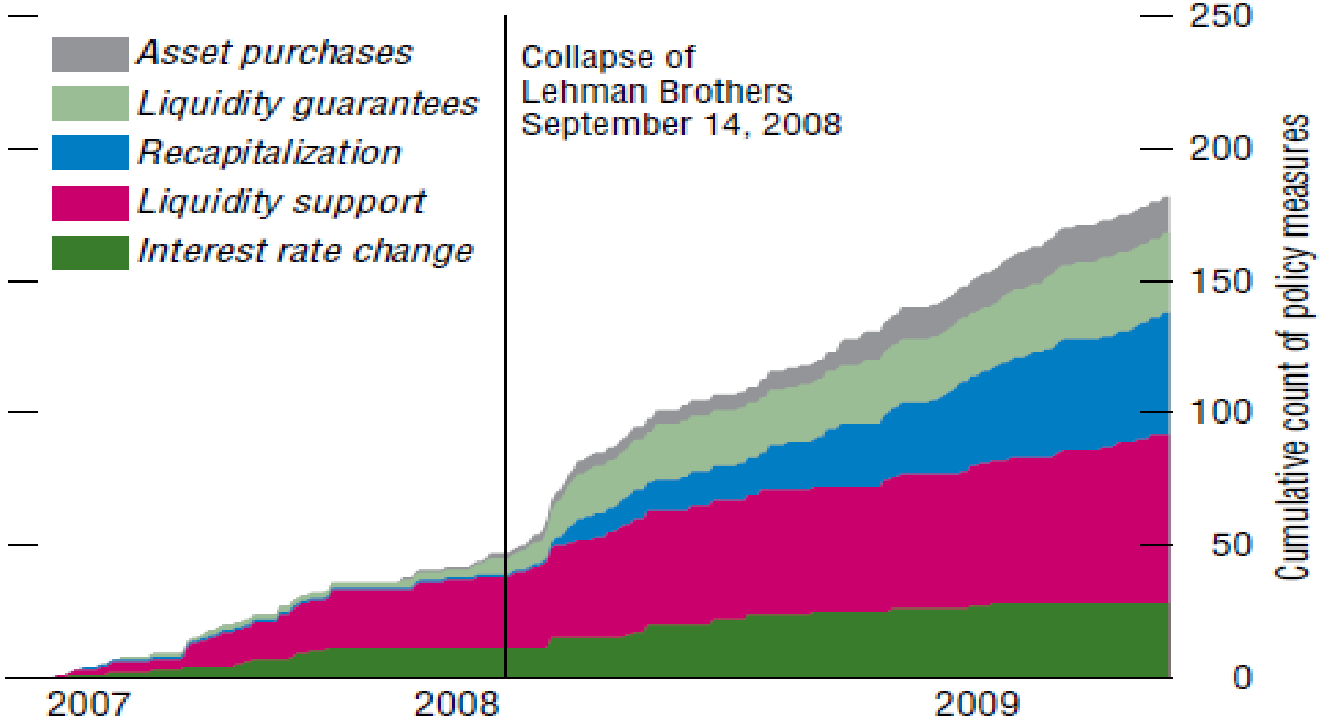
Exposición al riesgo inmobiliario: España 65% (36% titulizada), Japón y Australia 60%, Alemania 45%, EEUU 35%, UK 20%.

Elaboración: MAXIMIXE

Source : BBVA

Intervention measures during the crisis

Figure 3.1. Time Pattern of Crisis Measures in Sample Countries
(June 1, 2007–June 30, 2009; only front-page policy events)



Global Financial Stability Report Oct-2008

Financial regulators response

- Basel III (Capital and liquidity)
- Macroprudential policy
- Resolution of financial institutions
- Conduct of business

Basel Committee on Banking Supervision reforms – Basel III

Strengthens microprudential regulation and supervision, and adds a macroprudential overlay that includes capital buffers

	Capital					Liquidity
	Pillar 1			Pillar 2	Pillar 3	
	Capital	Risk coverage	Containing leverage	Risk management and supervision	Market discipline	Global liquidity standards and supervisory monitoring
All Banks	**Quality and level of capital** • **Raising minimum common equity** to 4.5% of risk-weighted assets, after deductions. • **A capital conservation buffer** comprising common equity of 2.5% of risk-weighted assets brings the total common equity standard to 7%. Constraints on a bank's discretionary distributions will be imposed when it falls into the buffer range. • **A countercyclical buffer** within a range of 0–2.5% comprising common equity will apply when credit growth is judged to result in an unacceptable build-up of systematic risk. **Capital loss absorption at the point of non-viability** Allowing capital instruments to be written off or converted to common shares if the bank is judged to be non-viable. This will reduce moral hazard by increasing the private sector's contribution to resolving future banking crises.	**Revisions to the standardised approaches** for calculating • **credit risk;** • **market risk;** • **credit valuation adjustment risk;** and • **operational risk** mean greater risk-sensitivity and comparability. **Constraints on using internal models** aim to reduce unwarranted variability in banks' calculations of risk-weighted assets. **Counterparty credit risk** More stringent requirements for measuring exposure; capital incentives to use central counterparties for derivatives; a new standardised approach; and higher capital for inter-financial sector exposures. **Securitisations** Reducing reliance on external ratings, simplifying and limiting the number of approaches for calculating capital charges and increasing requirements for riskier exposures. **Capital requirements for exposures to central counterparties (CCPs) and equity investments in funds** to ensure adequate capitalisation and support a resilient financial system. A **revised output floor**, based on Basel III standardised approaches, limits the regulatory capital benefits that a bank using internal models can derive relative to the standardised approaches.	A non-risk-based **leverage ratio** including off-balance sheet exposures is meant to serve as a backstop to the risk-based capital requirement. It also helps contain system-wide build-up of leverage.	**Supplemental Pillar 2 requirements** address firm-wide governance and risk management, including the risk of off-balance sheet exposures and securitisation activities, sound compensation practices, valuation practices, stress testing, corporate governance and supervisory colleges. **Interest rate risk in the banking book (IRRBB)** Extensive guidance on expectations for a bank's IRRBB management process: enhanced disclosure requirements; stricter threshold for identifying outlier banks; updated standardised approach.	**Revised Pillar 3 disclosure requirements** Consolidated and enhanced framework, covering all the reforms to the Basel framework. Introduces a dashboard of banks' key prudential metrics.	The **Liquidity Coverage Ratio** (LCR) requires banks to have sufficient high-quality liquid assets to withstand a 30-day stressed funding scenario that is specified by supervisors. The longer-term, structural **Net Stable Funding Ratio** (NSFR) is designed to address liquidity mismatches. It covers the entire balance sheet and provides incentives for banks to use stable sources of funding. The Committee's 2008 guidance ***Principles for Sound Liquidity Risk Management and Supervision*** takes account of lessons learned during the crisis. It is based on a fundamental review of sound practices for managing liquidity risk in banking organisations. **Supervisory monitoring** The liquidity framework includes a common set of intraday and longer-term monitoring metrics to assist supervisors in identifying and analysing liquidity risk trends at both the bank and system-wide level.
						Large exposures
SIBs	The Committee identifies global systemically important banks (G-SIBs) using a methodology that includes both quantitative indicators and qualitative elements. In addition to meeting the Basel III risk-based capital and leverage ratio requirements, G-SIBs must have higher loss absorbency capacity to reflect the greater risks that they pose to the financial system. The Committee also developed principles on the assessment methodology and the higher loss absorbency requirement for domestic systemically important banks (D-SIBs).					Large exposures regime established to mitigate systemic risks arising from interlinkages across financial institutions and concentrated exposures.

Source : BIS

Financial Stability Institute – FSI Insights

- Objective: analyze the evolution of the financial supervisory architecture since GFC
- Survey covering 82 jurisdictions
- Intitutional arrangements for financial sector oversight in:
  - Microprudential supervision
  - Macroprudential policies
  - Financial stability monitoring
  - Conduct of business supervision
  - Resolution of financial institutions

II. Financial sector supervisory models – concepts and evolution

Financial supervisory architecture requires a number of key institutional decisions

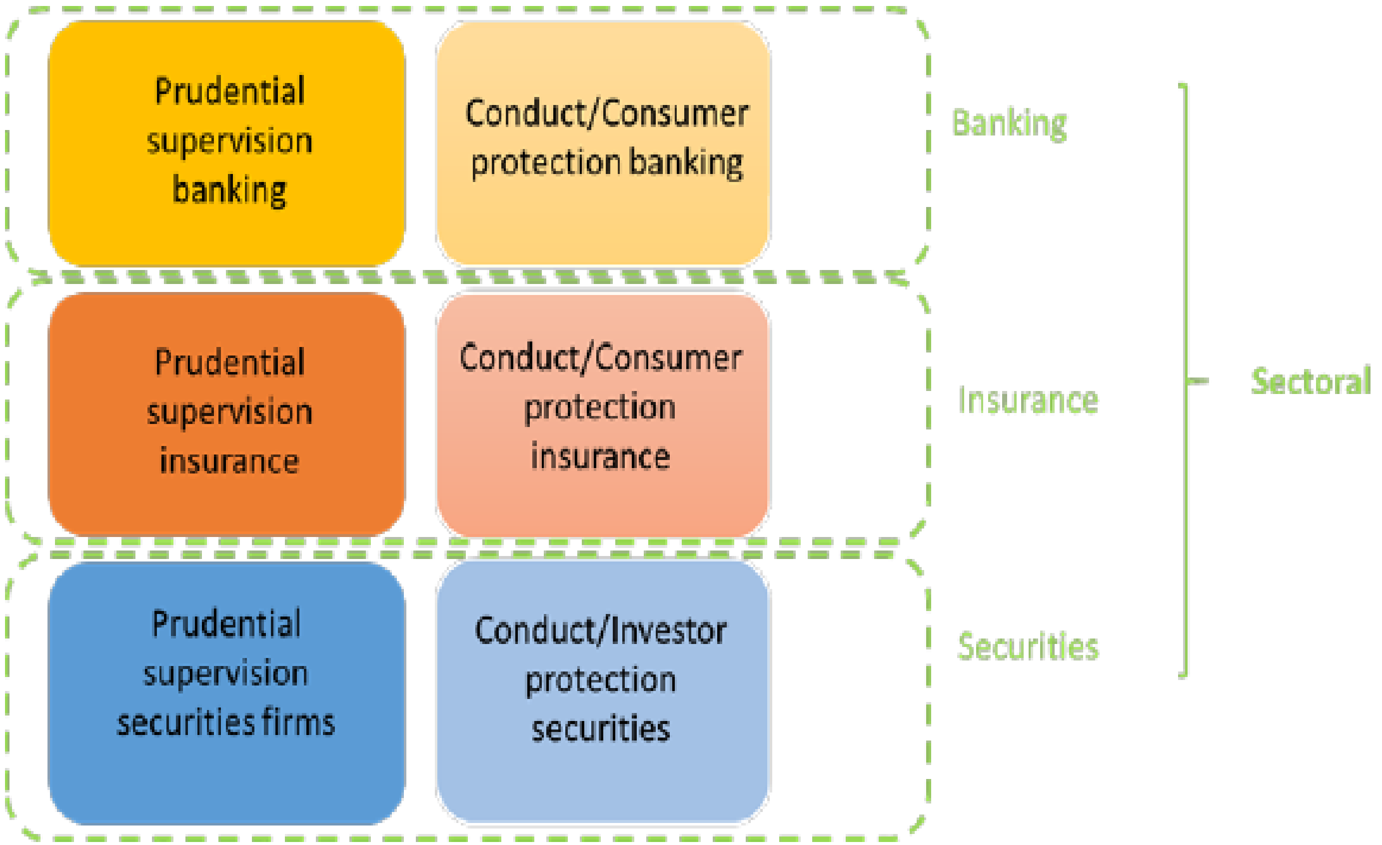
- Assigning specific functions to individual financial authorities
- Establishing coordination mechanisms
- Specifying approaches and arrangements to avoid potential conflicts of interest
- Rol of central banks in respect to financial sector oversigth

Potential benefits and costs of attaching additional financial supervisory responsibilities to the microprudential banking supervisor

Functions added	Potential benefits	Potential costs
+ Microprudential insurance	Similar required technical capacity Supervision of financial conglomerates	Potential confusion among beneficiaries of the safety net (deposit insurance)
+ Business conduct, consumer/investor protection	Integrated supervisory examinations Consumer/investor protection issues could signal some broader weaknesses, including prudential	Risk of subordinating investors' interests to a bank's solvency and profitability
+ Monetary policy (banking supervisor is the central bank)	Integrated liquidity, solvency and payment system oversight Better knowledge of transmission mechanism of monetary policy	Biases in monetary policy decisions Reputational risk
+ Macroprudential policy	Integrated financial stability assessment	Risk of subordinating macroprudential to microprudential objectives
+ Resolution of banks	Integrated crisis prevention and management Similar required technical capacity and better knowledge of institution	Risk of forbearance (ie delaying the trigger of resolution)

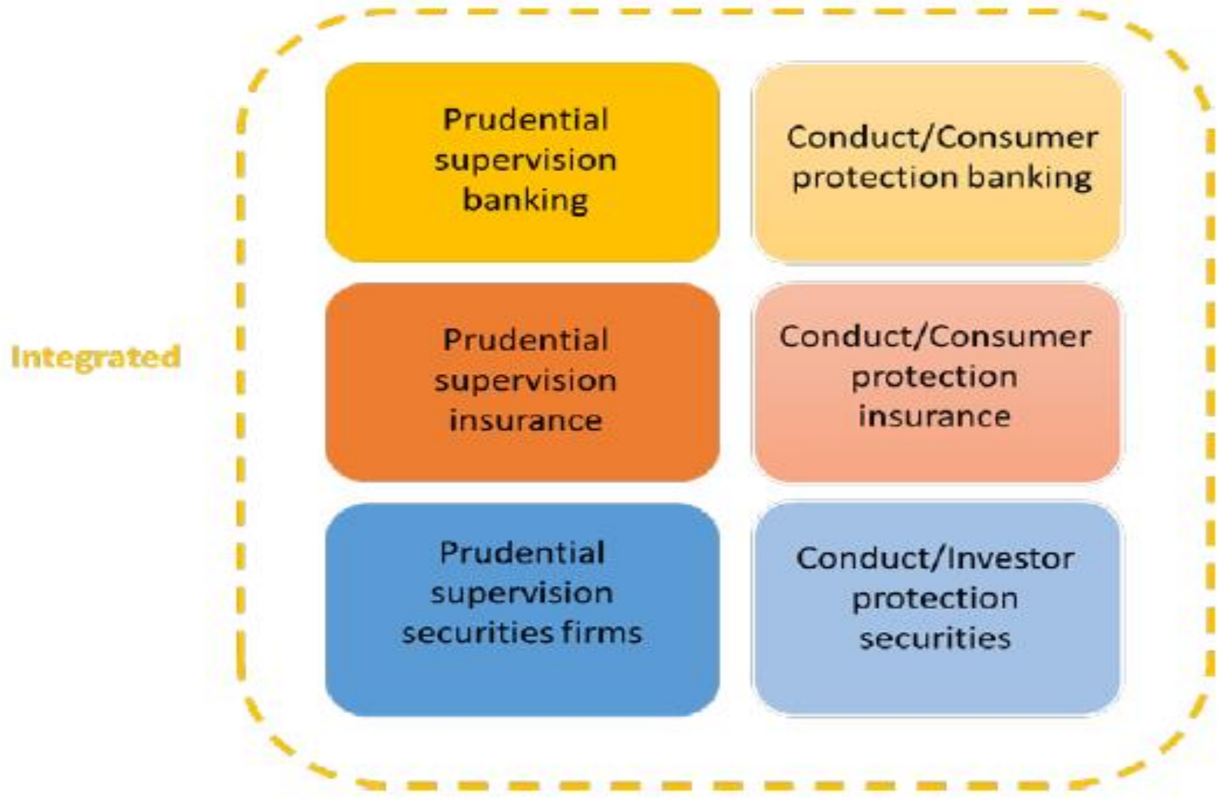
Sectoral model

One financial sector authority is responsible for the prudential and conduct of business supervision of each sector



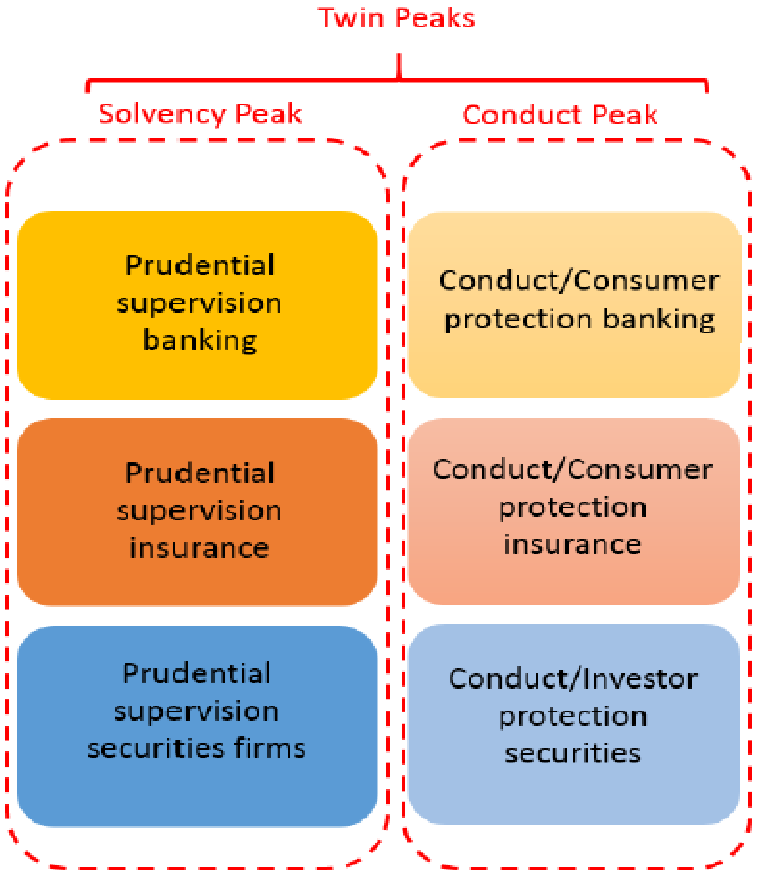
Integrated model

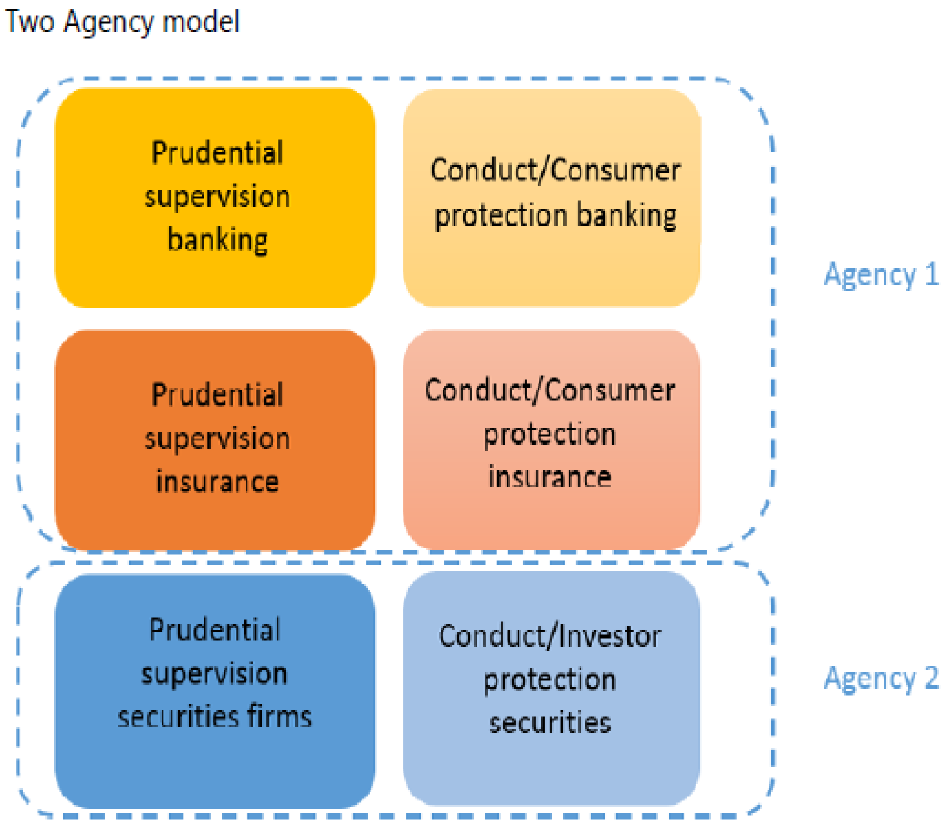
Single agency is responsible for all oversight functions in all three sectors



Partially integrated models

Responsibilities according to supervisory objectives or sectors





III. Post-crisis financial supervisory models

The prevailing model of financial sector supervision is still sectoral (50%)
The integrated model is employed by 30%

Model of supervision by region (percentage, rounded)

Table 2

	Africa		America		Asia & Pacific		Europe		Middle East		Total	
Sectoral	9	100%	9	52%	7	50%	10	30%	4	66%	39	50%
Integrated-CB	0	0%	1	6%	2	14%	5	15%	1	17%	9	11%
Integrated-SSA	0	0%	1	6%	2	14%	11	33%	0	0%	14	18%
Two Agency	0	0%	3	18%	1	8%	4	12%	1	17%	9	11%
Twin Peaks	0	0%	3	18%	2	14%	3	10%	0	0%	8	10%
Total	9	100%	17	100%	14	100%	33	100%	6	100%	79	100%

11 out of 79 jurisdictions have changed their supervisory model

Some jurisdictions have adjusted their existing supervisory model to improve the monitoring of financial stability and incorporate new functions, such as macroprudential policies and resolution, as well as to strengthen the coordination among the financial regulators

Changes in the model of financial sector supervision — Table 3

		Current					
	From \ To	Sectoral	Integrated-CB	Integrated-SSA	Twin Peaks	Two Agency	Total pre-GFC
Pre-GFC	Sectoral	39	1	3	1	2	46
	Integrated-CB	0	6	0	0	0	6
	Integrated-SSA	0	2	11	2	0	15
	Twin Peaks	0	0	0	5	0	5
	Two Agency	0	0	0	0	7	7
	Total current	39	9	14	8	9	79

Total changes	11

7 out of 19 jurisdictions (37%) have changed their supervisory model

Changes in model of financial sector supervision in crisis countries — Table 4

		Current					
	From \ To	Sectoral	Integrated-CB	Integrated-SSA	Twin Peaks	Two Agency	Total pre-GFC
Pre-GFC	Sectoral	5	1	1	0	1	8
	Integrated-CB	0	0	0	0	0	0
	Integrated-SSA	0	2	5	2	0	9
	Twin Peaks	0	0	0	1	0	1
	Two Agency	0	0	0	0	1	1
	Total current	3	6	5	3	2	19

Total changes	7

IV. Microprudential supervision

Central banks remain the predominant primary microprudential banking supervisor

Insurance companies and securities business are mostly supervised by an SSA

Current organisation of microprudential supervision[27]

Table 5

	Banking		Insurance		Securities/investment firms	
Central bank	54	66%	22	28%	13	17%
Separate supervisory agency	28	37%	52	65%	63	82%
Government department	0	0%	6	7%	1	1%
Total	82	100%	80	100%	77	100%

Few changes with respect to the location of the primary microprudential supervisor of banks since the GFC.

Changes in the primary microprudential authority for banking supervision — Table 6

	To / From	Current: Central bank	Current: Separate supervisory agency	Total pre-GFC
Pre-GFC	Central bank	48	1	49
	Separate supervisory agency	5	27	32
	Government department	1	0	1
	Total current	54	28	82

Total changes	7

The main change in the supervision of the insurance sector has been the migration from an SSA to the central bank.

Changes in the primary microprudential authority for insurance supervision — Table 7

	From \ To	Current: Central bank	Current: Separate supervisory agency	Current: Government department	Total pre-GFC
Pre-GFC	Central bank	14	0	0	14
Pre-GFC	Separate supervisory agency	7	49	0	56
Pre-GFC	Government department	1	3	6	10
	Total current	22	52	6	80

Total changes	11

Few changes have been observed since the GFC in the location of the microprudential supervisor for securities firms.

Changes in the primary microprudential authority for securities/investment services firms

Table 8

	To / From	Central bank	Separate supervisory agency	Government department	Total pre-GFC
Pre-GFC	Central bank	8	0	0	8
	Separate supervisory agency	5	62	0	67
	Government department	0	1	1	2
	Total current	13	63	1	77

Total changes	6

V. Macroprudential policy

CBs are the leading authority for macroprudential policy in the largest number of jurisdictions

The allocation of the macroprudential function varies more in jurisdictions where a SSA is the microprudential bank supervisor

Primary authority responsible for macroprudential policy — Table 13

Primary banking supervisor	Entity responsible for macroprudential policy	Recommendation only	Activation only	Recommendation and activation	Total
Central bank	Central bank	0	18	17	35
	Dedicated committee	5	0	5	10
Separate supervisory agency	Central bank	1	1	3	5
	Dedicated committee	7	1	3	11
	Separate supervisory agency	0	4	2	6
	Government department	0	2	2	4
Total		13	26	32	71

Dedicated committees are responsible for macroprudential supervision in a number of jurisdictions and typically include government representatives, central bankers and supervisory officials

Composition of a dedicated committee

Table 14

Composition of dedicated committees when it is the macroprudential authority						No of countries
Ministry or ministries	●	●	●	●	●	21
Central bank		●	●	●	●	20
Supervisory agency		●	●	●		19
Deposit insurance agency/authority			●		●	7
External experts				●		3
Total countries (21)	1	10	6	3	1	

Most jurisdictions have strengthened and continue to further develop their frameworks for financial stability monitoring

Changes in the setup of monitoring financial stability — Table 15

Creation of						Total
Dedicated committee (macroprudential authority)	●			●		21
Financial stability coordination committee		●			●	14
Financial stability unit or department			●	●	●	19
Total countries (45)	18	8	10	3	6	

VI. Financial supervisory architecture - EU and USA

European Union

- To further strengthen the supervisory structure in the EU, three European Supervisory Authorities (ESAs) were set up and started their operations in January 2011:
  - European Banking Authority (EBA)
  - European Securities and Markets Authority (ESMA), and
  - European Insurance and Occupational Pensions Authority (EIOPA)

- The European Systemic Risk Board (ESRB) was established to monitor and assess potential threats to financial stability that arise from macroeconomic developments and changes in the financial system

- The ESRB is responsible for macroprudential oversight of the financial system in the European Union and the prevention and mitigation of systemic risk

United States of America

- The supervisory structure has been strengthened after the GFC by focusing on financial stability and consumer protection. Dodd-Frank Act (2010) forms the basis for the creation of the inter-agency Financial Stability Oversight Council (FSOC) and the Consumer Financial Protection Bureau (CFPB). Both arrangements for financial oversight have a nationwide responsibility.

- FSOC: the objective is to monitor and identify emerging risks to financial stability across the entire financial system; identify potential regulatory gaps; and coordinate the microprudential agencies’ response to potential systemic risks.

- The FSOC is chaired by the US Treasury Secretary and comprises the heads of the Fed, OCC, FDIC, CFPB, SEC, CFTC, FHFA and NCUA plus an independent member.

VII. Conclusion

Conclusion

- Well-designed supervisory architecture contributes to strengthen the ability of financial authorities to prevent financial crises and mitigate their impact.
- Post-GFC, most jurisdictions have implemented incremental changes within their institutional arrangements for financial sector oversight. These changes respond to the adoption of the new macroprudential and resolution functions; a strengthening of consumer and investor protection; and improvements in financial stability monitoring.
- The post-GFC changes to financial supervisory models consist mainly in integrating supervisory functions and shifting more supervisory responsibilities to central banks.
- The regulatory and supervisory framework for business conduct has been strengthened worldwide.